

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

B p/s

CONSOLIDATED APPEALS:
77-5019, 77-5022

IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

In the Matter
of

STIRLING HOMEX CORPORATION

Gregory Jezarian, Geraldine Jezarian, Lonetown Company,
Harry E. Jones, Aleck Goldberg, as Custodian for Mark
Goldberg, and Mr. D. Windsor Dixon,

Appellants,

Frank G. Raichle, Reorganization Trustee; Lincoln First
Bank of Rochester; Chemical Bank; The Chase Man-
hattan Bank, N. A.; The First National Bank of Chicago;
Marine Midland Bank; and The Travelers Indemnity
Company,

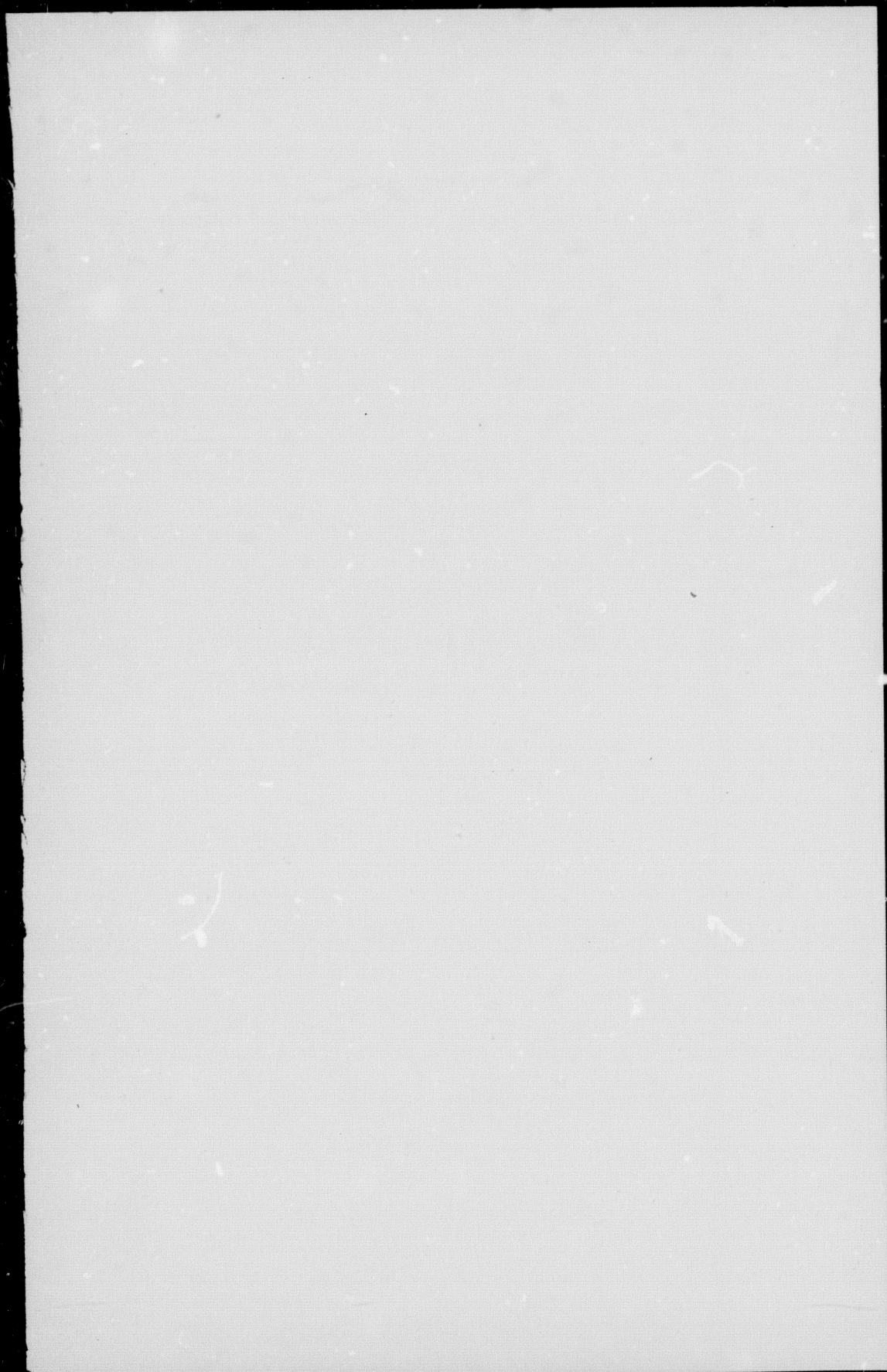
Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF NEW YORK

**BRIEF FOR APPELLEE, FRANK G. RAICHLE,
REORGANIZATION TRUSTEE**

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Harry E. Jones, Aleck Goldberg, as Custodian for Mark
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Appellants,

Frank G. Raichle, Reorganization Trustee; Lincoln First
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Company,

Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF NEW YORK

**BRIEF FOR APPELLEE, FRANK G. RAICHLE,
REORGANIZATION TRUSTEE**

These are consolidated appeals in a Chapter X reorgani-
zation from an order of the District Court for the Western
District of New York, Hon. Harold P. Burke, D. J., which

classified the claims of allegedly defrauded stockholders as subordinate to the claims of conventional general creditors (A.* 446). The debtor, Stirling Homex Corporation, has been determined to be insolvent (A. 266) and the classification complained of was made under Section 197 of the Bankruptcy Act and Rule 10-302 of the Rules of Bankruptcy Procedure upon the application of the Trustee who is in the process of preparing a plan of orderly liquidation (A. 443).

It is well settled that a plan of orderly liquidation is appropriate in Chapter X where reorganization is unattainable. *See, e. g.*, Section 216 (10) of the Act, 11 U. S. C. 616 (10); *In re Porto Rican American Tobacco Co.*, 112 F. 2d 655, 657 (2d Cir. 1940); *Country Life Apartments v. Buckley*, 145 F. 2d 935, 938 (2d Cir. 1944); *In re Lorraine Castle Apartments Bldg. Corporation*, 149 F. 2d 55, 58-59 (7th Cir. 1945); *Patent Cereals v. Flynn*, 149 F. 2d 711, 712 (2d Cir. 1945); *Bankers Life and Casualty v. Kirtley*, 338 F. 2d 1006, 1009-1010 (8th Cir. 1964).

In our view the "Question Presented" is as stated in the brief of the Securities and Exchange Commission, p. 1,

"Whether the claims of holders of shares of preferred and common stock of a debtor under Chapter X of the Bankruptcy Act, who were allegedly defrauded into purchasing those shares, should be classified as subordinate to those of debtor's unsecured creditors for purposes of the plan of reorganization and its acceptance."

We make no counterstatement of the case and accept as substantially correct the "Statement of the Case" as contained in the brief of the Securities and Exchange Com-

* "A" refers to Joint Appendix, Vols. I and II.

mission pp. 2-9.* For a more detailed history of the debtor Stirling Homex Corporation and of this complicated and many faceted bankruptcy proceeding we refer the Court to the Trustee's report pursuant to Section 167 (1) of Chapter X, 11 U. S. C. 567 (1) (A. 154-175) and the Trustee's testimony at the hearing on the subject of a substantive consolidation and the settlement of the banks' claim (A. 61-107).

Before discussing the points raised, we call attention to the fact that all of the named appellants had notice of this bankruptcy proceeding from its beginning and that, as conceded in appellants' brief at p. 17, "All the claimants-appellants were shareholders of record when notice was given of the bar order". (A. 42).

While the Trustee prefers to have the question of the classification decided in accordance with law and the equities of the case, he desires to dispel at the outset any impression that might be gained that the named appellants were lacking in notice and, indeed, knowledge of every important step taken in this case. The appellants Harry E. Jones and Aleck Goldberg as Custodian for Mark Goldberg filed claims as allegedly defrauded stockholders (A. 27 *et seq.*). So have other 5 or 6 present stockholders.

* Appellants' statement of the case is argumentative and reflects the insurmountable bias of their counsel.

POINT I

Answering appellants' Point I, the District Court did not abuse its discretion in directing that for the purpose of a plan of orderly liquidation and a distribution of the proceeds of such liquidation the claims of "defrauded stockholders" be subordinated to the claims of orthodox and conventional unsecured creditors.

In directing the subordination of the claims of so-called defrauded stockholders, the District Court was following the general rule of equity as well as equitable considerations peculiar to this case.

"As a general rule equity prefers the claims of innocent general creditors over the claims of shareholders or subordinated creditors deceived by officers of the corporation." *F. D. I. C. v. American Bank Trust Shares, Inc.*, 412 F. Supp. 302, 308 (1976).

Language directly in point with the case at bar is that of the court in *Carter v. Bogden*, 13 F. 2d 90 (1926). The reporter's Note 1 in that case reads as follows:

"Claims of innocent creditors of bankrupt corporation entitled to preference over those of stockholders deceived by its officers."

In the course of its opinion in that case the Court said at 93-94,

"Anyone, becoming a creditor of a corporation, has a *right* to rely on the security afforded by the money or assets paid in by the stockholders for its capital stock, and in a proper case equity will prefer the claims of innocent general creditors over claims of stockholders deceived by officers of a corporation. (Citing cases.)" (Emphasis added.)

This is our point exactly!

In the case of *Scott v. Abbott*, 160 F. 573 (1908), *cert. denied* 213 U. S. 572, 53 L. ed. 655, the Eighth Circuit developed the history of the general rule that calls for the subordination of the so-called defrauded stockholders' claims to the claims of general unsecured creditors. In the course of its opinion the Court stated at 582,

"In view of the foregoing facts and principles the rights of the innocent general creditors are superior to those of the deceived stockholders."

The facts were similar to our case. In another case the Court said:

"Courts have repeatedly frowned upon the attempt of a stockholder at the bankruptcy to 'lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor.'" *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713 (W. D. Mich., 1938) p. 715.

See, also, this Court's opinion in *Matter of Cartridge Television, Inc.*, 535 F. 2d 1388 (1976) and the District Court's opinion in *Matter of Weiss Securities, Inc.*, 425 F. Supp. 212 (1977).

In the face of the foregoing cases we are somewhat at a loss to understand how counsel could summon up the hardihood to make a subpoint heading in appellants' brief which reads as follows: "A. The authorities uniformly rank defrauded stockholders with other general creditors" (appellants br. p. 25) and make the positive statement that "There is no precedent or authority for ranking stockholders' fraud claims below claims of conventional general creditors . . ." (*ibid.* 25); further, "the notion that stockholders' fraud claims should be subordinated to claims of so-called conventional general creditors seems to stem

solely from an article by two law professors . . ." (*id.* 26), and worst of all, "Lower court decisions involving this issue have uniformly either explicitly ruled in favor of parity treatment for defrauded stockholders or else have assumed as much." (*id.* 27).^{*} Counsel does not cite a single bankruptcy case or authority in support of these unfortunate and erroneous statements.

The District Court's disposition of the matter of subordination in the case at bar reads as follows:

"On all the evidence it is hereby

"ORDERED that, in the exercise of discretion the claims of allegedly defrauded stockholders are classified as subordinate to the claims of conventional general creditors." (A. 446)

In so disposing of the question presented, the District Court was exercising its general equity powers and those conferred upon it by Section 197 of the Bankruptcy Act which reads as follows:

"For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock." (A. 443)

and acting in accordance with Rule 10-302 of the Rules of Bankruptcy Procedure which provides in pertinent part as follows:

"For the purpose of the plan and its acceptance, the court may fix, after hearing on such notice as it may direct, the division of creditors and stockholders into classes according to the nature of their respective claims and stock." (A. 443)

^{*} In all good humor we observe that perhaps the answer to our quandry lies in the fact that counsel's research was not conducted with his characteristic thoroughness.

The Advisory Committee's note to the above rule makes clear that the classification of creditors' claims can be made "before the trustee formulates his plan if the court's instructions on proper classification are needed to enable the formulation of the plan." The classification is obviously needed in the case at bar (A. 152 *et seq.*).

A classification hearing under Section 197 of the Bankruptcy Act

"... is simply a method of recognizing difference in rights of creditors which calls for difference in treatment.

"The statute affords the court a broad latitude in classification of creditors, and classification should be based on substantial differences in the nature of claims." (*Scherk v. Newton*, 152 F. 2d 747, 750-751 [10th Cir., 1945]).

Even without the express provision of Section 197, it is to be remembered that courts of bankruptcy sit as courts of equity. In the leading case of *Pepper v. Litton*, 308 U. S. 295, 304-305, 84 L. ed. 281 (1939), the United States Supreme Court said:

"Consequently this Court has held that for many purposes 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity'. (Citing cases.) By virtue of § 2 a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the act, it applies the principles and rules of equity jurisprudence. (Citing cases.)"

and, further,

"The bankruptcy courts have exercised these equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates.

... For certainly if, as provided in the latter section [§ 57 (k)], a claim which has been allowed may be later 'rejected in whole or in part, according to the equities of the case,' disallowance or *subordination* in light of equitable considerations may originally be made." (Emphasis added.)

The *Pepper* case was cited by Judge Anderson of this court in 1961 when he was sitting as a district judge in the case of *Linco Manufacturing Co., Inc.*, Debtor, 201 F. Supp. 899. In the *Linco* case Judge Anderson, exercised his equitable powers and directed that certain claims be subordinated to the claims of other creditors (citing cases). Among other cases, Judge Anderson cited *Carter v. Bogden*, *supra*. See also the following:

"The reorganization court as a court of equity has broad powers in the matter of classifying creditors and shareholders, and it necessarily has full power to subordinate interests or classes of interests where the equities demand. See 6A Collier on Bankruptcy ¶ 9.15 at 259-261 (14th ed.)." *In re Four Seasons Nursing Centers of America, Inc.*, 472 F. 2d 747-749 (1973).

Commenting upon the claims of allegedly defrauded stockholders in the *Cartridge Television* case, *supra*, this Court said,

"Furthermore, the contingent claimants here are not, and may never become, creditors of the corporate debtor. At this stage they remain stockholders. *To permit them to delay the normal winding up of a corporate bankrupt's estate would be to undercut the utility of the bankruptcy laws where corporate debtors are involved.*" (Emphasis added.) 535 F. 2d 1388, 1390-1.

In urging a settlement of the claims of so-called defrauded stockholders in the case at bar, their counsel said on the argument before the District Court,

"The alternative is to litigate a number of rather thorny issues for adjudication by Your Honor." (A. 218).

Further, and conceding the element of delay in winding up the estate which this Court discussed in the *Cartridge Television* case, *supra*, counsel for the so-called defrauded stockholders stated,

"The alternative [to a settlement], I think, would delay distribution and wind-up of the reorganization for a rather *lengthy period*." (A. 220)

Counsel again referred to the fact that litigation of the defrauded stockholders' claims would have the result that

"... distribution and wind-up or liquidation would be delayed for a *considerable period of time* if this issue cannot be compromised . . ." (A. 221).

While our case differs from the *Cartridge Television* case in that we have not asked that the claims of the so-called defrauded stockholders be disallowed as such, but rather that for reasons of equity and fairness they be subordinated to the claims of orthodox and conventional general unsecured creditors, as was done in *Carter v. Bogden*, 13 F. 2d 90 (8th Cir. 1926); *Scott v. Abbott*, 160 Fed. 573 (8th Cir. 1908), and kindred cases,* many of the considerations discussed by this Court in the *Cartridge Television* case apply to the case at bar, including the element of delay in winding up the bankruptcy estate.

As stated by this Court in the *Cartridge Television* case, the "*purpose*" of the Bankruptcy Act is

"... to promote the *prompt* liquidation of each debtor's estate and the expeditious distribution of the pro-

* Concededly the result is the same under the facts of this case—so should be the pertinent considerations.

ceeds to the bona fide general creditors holding provable claims so that they will not be forced to wait unduly long for the payments due them." (Emphasis added.) 535 F. 2d 1388, 1391.

Despite the efforts of the Trustee, which counsel for appellants was kind enough to describe as "Herculean" (A. 257), it has taken five years for the Trustee to liquidate the inventory of 10,000 completed modules; to audit and dispose of by settlement or litigation countless claims filed against the debtor's estate aggregating \$99 million (A. 166) and to thereby reach a point where a plan of orderly liquidation can now be submitted to the creditors (except for the belated intrusion of the allegedly defrauded stockholders).

Since class action status of stock fraud claims cannot be allowed in bankruptcy (A. 44-46),* what is requested is that the Trustee now be directed to spend thousands of dollars to attempt to ascertain the names and addresses of *past* stockholders of Stirling Homex and spend additional thousands of dollars to advertise for individual claims from those stockholders, past and present, who may consider themselves to have been defrauded, which claims counsel for appellants estimate will aggregate \$100 million. It is apparent that this estate, consisting of \$16 million or \$17 million in assets could not then be settled for years to come and that the cost of litigation provoked by an invitation to file such claims will substantially erode the estate. At least it will not serve "... to effectuate a 'paramount objective of bankruptcy proceedings, that of expeditious administration', 3 Collier on Bankruptcy, *supra*, ¶ 57.15 at 247." (*Cart-ridge Television* case at 1392.)

* See also appellants' br. p. 19.

Counsel for appellants insist upon asserting that the past and present stockholders of Stirling Homex have "readily provable claims." It may or may not subsequently develop (how much later we cannot say) that they have claims. This depends upon many factors, but certain it is that their claims are not readily provable claims, let alone, to use the words of art, "allowable" or "provable" under the Bankruptcy Act.

In this connection we do not believe that we are amiss to mention the fact that the class actions brought by the same able and experienced counsel who represent appellants against former management of Stirling Homex and others on the same grounds have been pending for almost six years and are still in the discovery stage. Counsel for appellants concede that class action status cannot be accorded the so-called defrauded stockholders insofar as their claims in bankruptcy are concerned and seek a direction to the District Court to "instruct the Trustee to *solicit** fraud claims from individual stockholders, past and present, for filing hereafter by a prescribed date." While such a course of action would open up enticing vistas of endless litigation to the undoubted delight of a whole generation of lawyers, few of those invited to the party would live to see its end. Counsel for appellants state in their brief that there are tens of thousands of stockholders, past and present, to be solicited and that their individual claims are estimated to amount to \$100 million in the aggregate.

In sum, the spectre envisioned by this Court in the *Cartridge Television* case has become a threat incarnate in the case at bar. The Trustee cannot put his dilemma more

* "Solicit" seems like a particularly sinister and inappropriate word to use in this connection.

clearly than did this Court in the *Cartridge* case when it said:

"By making contingent and unliquidated securities fraud claims both provable and nonexpungable, appellants' position would weaken severely the priority position of the general creditors. Shareholders who simply alleged securities law violations that were not patently frivolous could threaten substantial delay in the administration of a corporate bankrupt's estate. *Given the often protracted nature of securities litigation, it is not difficult to foresee trustees being forced to settle contingent claims of highly questionable merit in order to avoid unnecessary delays in distribution.*" (Emphasis added.) 535 F. 2d 1388, 1391.

Apropos of the italicized language of this Court in the *Cartridge Television* case, *supra*, it is to be noted that every bankruptcy case cited by appellants' counsel, which included a participation by so-called defrauded stockholders, was the result of a settlement. We cannot put the proposition clearer than did appellants' counsel in his candid statement contained in his brief to the District Court, p. 11, that

"In all the foregoing instances [*Four Seasons Nursing Centers of America, Inc., Equity Funding Corporation of America, Westec Corp., and others*] the issue was resolved by settlement rather than litigation; concededly, therefore, these are not rulings which mandate participation by defrauded security holders over a Trustee's objection."

See, also, paragraph designated "3" of letter of appellants' counsel to Trustee of December 21, 1976 (A. 414).

Furthermore, even in the cases that were settled by providing something for the so-called defrauded stockholders, they were not permitted to share *pari passu* with the orthodox general creditors. Importantly, not one of the settled

cases involved a plan of liquidation but, on the contrary, a conventional reorganization which resulted in a continuing viable entity. Significantly, too, what the defrauded stockholders received in settlement of those cases in layman's language *came out of what the other stockholders would have received and not out of the orthodox and conventional general creditors. The conventional creditors were provided for in full.*

The subordination of the so-called defrauded stockholders' claims to the claims of the orthodox and conventional unsecured creditors is further justified, indeed called for, by the equitable considerations of the investment expectations of the parties. The equity investor, a stockholder if one pleases, is seeking equity profits—high profits in our case, many times the issue price—and assumes equity risks. Orthodox and conventional creditors, such as lenders, suppliers and workers, seek only a normal business profit. They bargain for debt type profits and certainty of payment. Stockholders are often prepared to wait long periods of time for substantial profits, whereas lenders and trade creditors, to say nothing of workers, expect a reasonably prompt payment.* Here they have waited five and one-half years, and if appellants could prevail, face the prospect of years of further waiting.

Importantly, too, a subordination prevents straddling tactics by allegedly defrauded stockholders. A security holder seeking to rescind is attempting to avail himself of an alternative that the general creditor does not have. To use a current expression, he has the best of two worlds.

* The claims of orthodox and conventional unsecured creditors include the claims of hundreds of workers and small suppliers (A. 166).

If things go well he can elect to be a stockholder. If things go poorly, he seeks to be a creditor. The so-called defrauded stockholders in the case at bar* have waited over five years since the filing of the bankruptcy petition on July 12, 1972 to threaten to make claims against the bankrupt estate. They waited until it was apparent that there was to be a liquidation and not a reorganization in the sense of floating out of the trusteeship a viable operating company. For the most part they had ratified their status as stockholders by attending meetings or voting proxies and, in the case of preferred stockholders, by accepting dividends as late as April 1972. The great majority of all stockholders have heretofore filed statements with the Trustee alleging their status to be that of stockholders. We submit that it is too late in the day for them to assume a different role.

Another equitable consideration inheres in the fact that the allegedly defrauded stockholders have other remedies not available to lenders, suppliers or workers, including actions against the members of former management, underwriters, broker dealers, accountants and others who they may claim committed the alleged frauds of which they complain.**

"If the subscriber became a shareholder in consequence of frauds practiced upon him by others, whether they be officers of the bank or officers of the government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder, within the meaning of § 5151, if at the time the rights of creditors accrued, he

* except for a negligible few, six in number, totalling \$21,869 (appellants' br. p. 13, A. 173).

** more specifically, claims under the Securities Acts *not available to creditors*.

occupied and was accorded the rights appertaining to that position." *Scott v. Deweese*, 181 U. S. 203-213, 21 Sup. Ct. 585, 45 L. ed 822.

The so-called defrauded stockholders in the case at bar are pursuing such remedies (A. 417).

The District Court's opinion gives a further cogent reason for subordination in the following language:

"If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or subcontractors, be free as they now are to extend credit to the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities, without first obtaining a secured basis which will guarantee them a priority status in the event their customer defaults. Such a fundamental change in the financial structure of the business community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority." (A. 444)

The reasoning of the District Court grows on one the more one reflects upon the inequitable effect of rescission claims of defrauded stockholders if allowed on a *pari passu* basis with orthodox and conventional creditors. The rescission doctrine would permit claims for large amounts because rescission under the Federal Securities laws potentially permits a stockholder to claim much more than the debtor's original selling price of the stock. We do not have to go further than the situation in the case at bar to illustrate this point. The debtor made two public offerings of its stock (A. 157). It received \$6 million as a result of its first offering in 1970 (A. 157) and \$19 million as a result

of its second offering on July 31, 1971 (A. 157). The common stock, which was issued for \$16.50 per share, traded at prices as high as \$50 per share a few months later (A. 157). As stated in appellants' brief, p. 5,

"Of the \$39 million in total proceeds of the two offerings, the debtor realized \$25,100,000. A157. The loss to shareholders, taking account of intermediate market fluctuations in excess of the offering prices, while difficult to estimate, could be as much as \$100,000,000. A157, A219."

If the estimate of appellants' counsel is correct, the claims of defrauded stockholders would approximate four times the amount of money which the debtor received for the sale of its stock. As stated by Messrs. Slain and Kripke in their much discussed article,*

"A creditor who has relied . . . upon the existence of a \$10 equity cushion under his claim against the issuer may see the \$10 equity cushion turn into a \$40 competing claim."

In such an order of things we ask, rhetorically, who is going to extend credit as a lender or supplier?

And, further, and to the same effect, as the District Court's opinion and as one commentator put it,

"A general creditor is entitled to a higher priority position because of the nature of the investment. When a creditor makes a loan after the stockholders have contributed capital to the corporation, the creditor relies upon the equity cushion of the stockholders. *The reliance need not be manifest—the stockholders are presumed to have knowledge of priority rights.* The court so held in *In re Irving Whitehouse Co.*** The court recognized the right of creditors to rely upon the

* 48 N.Y.U.L.R. 261 (1973).

** 293 F. 287 (9 Cir. 1923).

shareholders' capital contribution. Credit is given to corporations with little or no knowledge of names of stockholders, but with confidence that, whoever they are, their rights in and to corporate property are subordinate to the rights of creditors. Thus, the creditor who has made a loan after stockholders or subordinated debt holders have invested in the corporation has a superior equity to the junior claimants, and should not be subjected to equal treatment with the rescinding security holders. (The Defrauded Investor', American Bankruptcy Journal, Vol. 50, 1976, p. 205.)" (Emphasis added.)

See, also, Slain and Kripke, *supra*.

The question before the court was sought to be resolved by the Commission on Bankruptcy and the National Conference of Bankruptcy Judges who have proposed a general rule of subordination in contrast to the case-by-case approach. The proposed amendment to the Bankruptcy Act would subordinate defrauded shareholders' claims to the claims of general creditors. Proposed section 4-406 (a) (1) provides:

"(a) SUBORDINATED CLASSES OF CLAIMS.—The following claims are subordinated in payment to all other nonsubordinated but allowable claims:

"(1) any claim for rescission of the purchase of securities issued by the debtor corporation or for damages resulting from the purchase or sale of such securities."

The consensus among the members of the Commission on Bankruptcy and the National Conference of Bankruptcy Judges that the claims of so-called defrauded stockholders should be subordinate to the claims of orthodox and conventional creditors is not only interesting but importantly it reflects the thinking of those knowledgeable in their field.*

* For a statement of the status of the proposed amendment see footnote on page 34 of appellants' brief.

It should be kept in mind that the Plan for which the classification of claimants was made in the case at bar is not a Plan of Reorganization in the sense of floating out a viable operating company. In the light of the conceded, established and determined fact that the consolidated debtor is hopelessly insolvent (A. 266), the only fair and equitable plan is one which provides for an orderly liquidation of the debtor's assets and the distribution of the proceeds among its creditors. Thus, the situation is similar to that presented in the *Cartridge Television* case. As stated in that case, the "stock fraud claims are both contingent and unliquidated" and "Furthermore, the contingent claimants here are not, and may never become, creditors of the corporate debtor." A determination of their claims does involve serious, unsettled, factual and legal issues and substantial disputes will arise in determining the proof required to establish the claims of any allegedly defrauded stockholder in this case, the application of periods of limitations and the measure of damages.

Appellants' reliance upon the case of *Oppenheimer v. Harriman National Bank and Trust Co.* is misplaced.

In 1937 the Supreme Court held in the case of *Oppenheimer v. Harriman National Bank and Trust Co.*, 301 US 206, 81 L. ed. 1042, that a defrauded stockholder who had paid for his stock out of a deposit he had with the bank at the time of purchase and who had paid his assessment was entitled to have his claim ranked equally with the claims of other depositors and unsecured creditors. The stockholder was induced to purchase the bank's stock by its officers' false and fraudulent misrepresentations.

The *Oppenheimer* case is readily distinguishable from the case at bar in two ways—first, the statute in national

bank cases requires a "ratable distribution on *all claims*" and vests no equitable powers in the controller making the distribution of assets to do otherwise. Thus, the situation in *Oppenheimer* was unlike a distribution under a plan comprehended by Chapter X of the Bankruptcy Act which requires a "fair and equitable" distribution. *Oppenheimer* was a national bank liquidation under the National Bank Act, § 194, which reads in pertinent part as follows:

" . . . the controller *shall* make a ratable dividend of the monies so paid over to him by such receiver on *all* such claims as may have been proved to his satisfaction . . ." (Emphasis added.)

Here, however, we are dealing with a situation where the bankruptcy court in the exercise of its general equitable powers and those specifically granted by § 197 of the Bankruptcy Act has fixed "the division of creditors and stockholders into classes according to the nature of their respective claims and stock." In other words, in the *Oppenheimer* case the command of the statute, irrespective of considerations of fairness and equity, was plain and unmistakable. The distribution was to be, in the words of the statute, "ratable." In the case at bar the District Court in the exercise of discretion on the totality of the facts presented, reached the conclusion that a ratable distribution would not be "fair and equitable."

As observed by the Court in *Atlantic Gypsum Co. v. The Federal National Bank of Boston*, CCA Mass. 1935, 76 F. 2d 59,

"Liquidation of national banks is controlled by statute;
 . . ."

A different statute from the one governing the case at bar.

In *Uhl v. First National Bank and Trust Co.*, 24 Fed. Supp. 275, aff'd 94 F. 2d 1013, *certiorari denied*, 304 U. S. 584, 82 L. ed. 1546, the Court said that the "obvious purpose" of the statute "is to secure equality of distribution of the assets of an insolvent bank among its creditors." The statute recognizes no such thing as classes of creditors according to the nature of their claims.

Secondly, *Oppenheimer* is distinguishable from the Chapter X securities fraud cases because it was decided before the advent of the 10b-5 cases. The *Oppenheimer* court did not contemplate the extent of recovery later permitted under Rule 10b-5. Rescission at the time of *Oppenheimer* meant that the defrauded purchaser would receive restitution of the amount paid to the debtor. In *Oppenheimer* the amount was a small sum—only \$12,187.00. As we observed before, rescission under the Federal Securities Laws potentially permits the purchaser to receive much more than the debtor's selling price for the stock. The potential exposure to a company like Stirling Homex is almost unlimited. The company had over 9 million common shares of stock outstanding which traded as high as \$50 per share and after July 31, 1971 500,000 shares of preferred stock. As we keep reiterating, counsel for the appellants told the District Court that he estimated claims of so-called defrauded stockholders at \$100 million.

Additional facts on which the District Court exercised its discretion.

The experienced District Judge who directed the subordination in the case at bar had had a long and intimate contact with all of the innumerable proceedings had and taken in the tortuous course of this many faceted bankruptcy case. See the 23 pages of Docket Entries at pages

1 through 23 of the Joint Appendix. As the cases hold, the exercise of his informed discretion should be given great weight.

Among other things, the District Judge had approved the settlement made between and among the Trustee and the bank creditors on June 29, 1976 (A. 142). This was the settlement as a result of which the banks surrendered their secured position and assumed the role of general unsecured creditors and received a \$7 million payment on account of their allowed claims as general unsecured creditors in the aggregate sum of approximately \$38 million (A. 55-60). The banks had been informed that the total claims as audited and accepted by the Trustee filed against the debtor and its subsidiaries (exclusive of the claims of the banks) prior to the expiration of time set forth in the bar order aggregated approximately \$12.5 million. See Settlement Agreement, paragraph II (A. 55). The banks obviously relied upon such fact and were thus induced to settle and to withdraw their then pending objections to a substantive consolidation. Certain it is that the banks would not have settled if there were a basis to believe that the \$12.5 million aggregate of claims in addition to the banks' claims would swell by \$100 million before distribution could be made.

Important to bear in mind is that all of the named appellants had received notice of the proposed settlement and the proceedings leading to its approval by the Court (A. 65, A. 113).^{*} None of them appeared in person or by counsel. No one, including the SEC, which was vigilant throughout these proceedings to protect public stockhold-

^{*} All were stockholders of record as of the date of the notice (appellants' br. p. 17).

ers, objected. The matter of the resolution of the dispute between the banks and the Trustee was referred by the District Court to Bankruptcy Judge Hon. Edward D. Hayes. Judge Hayes held a hearing on May 10, 1976 (A. 62). The Trustee testified at length and relevant documentary evidence was received (A. 64-107). Judge Hayes made findings and recommended approval of the Settlement Agreement between and among the Trustee and the banks (A. 108-114). Judge Hayes' report containing his findings and recommendations was reviewed by the District Judge and after a hearing was approved by him (A. 142, A. 148).

The settlement occasioned the letter of the Pomerantz firm of December 21, 1976 to the Trustee which sheds light on the considerations which gave rise to the belated discussion of possible claims on the part of the *past* stockholders* (A. 414-416). If the timely filed claims of Jones and Goldberg and other present stockholders were properly subordinated, as indeed they were, any claims of past stockholders should be similarly subordinated.

The banks protected themselves in paragraph 3.2 of the Settlement Agreement against the allowance of *pari passu* claims in excess of the aggregate of \$50,168,206, including their own (A. 56). Accordingly, the practical result of ranking claims of so-called defrauded stockholders on the same basis as the claims of orthodox and conventional creditors will primarily affect and greatly dilute the distribution to small suppliers and workers, rather than the distribution to the banks.

* The letter reveals the fact that counsel for the so-called defrauded stockholders, notice or no notice, was closely following the bankruptcy proceedings and had full and complete knowledge concerning them.

If a case by case approach to the solution of the classification of claims of so-called defrauded stockholders, past and present, rather than the application of a general rule such as suggested by the cases is to be followed, then in this case of a *liquidation*, an affirmance should be directed and the classification to be made in the case of a conventional reorganization which permits of a continuation of a viable entity can be made when such a case is presented. The classification by the District Court was made "On all the evidence"* (A. 446) by the District Judge who had seen an attempted conventional reorganization of necessity turned into a liquidation.

While we recognize the expertise of the Securities and Exchange Commission and welcome its participation in this involved bankruptcy proceeding, we are confused by the last two pages of the Commission's brief. At page 17 of the brief the statement is made that "the classification should be determined by the equities present in the particular case",** citing the *Four Seasons Nursing Centers* case, *supra*. At page 18, under the heading "CONCLUSION", the brief states,

"For the foregoing reasons, the order under review should be reversed and the case should be remanded with instructions that the classification of defrauded stockholders should be decided on the equities presented by this case."

This is exactly what was done! A hearing was duly noticed and held (A. 191-265). All parties who appeared

* The District Court was not required to review and recite all the evidence in his opinion order.

** Thus, it is clear that the Commission agrees with us that the *Oppenheimer* case is not controlling and that the equities involved in our case are properly determinative of the result.

were heard (A. 191-265). Testimony was taken and relevant documentary evidence was received, including the Trustee's section 167(1) report (A. 247-248). No party was denied a full and complete opportunity to offer testimony or documents (A. 191-265). No party made an offer of proof which was excluded (A. 191-265). No party asked for a postponement in order to make an offer of proof (A. 265). The experienced District Judge who was possessed of all the facts that could possibly be considered on a remand exercised his discretion and in the words of the Commission's brief, determined the classification "by the equities presented in the particular case", stating in his opinion that

"On all the evidence it is hereby

"ORDERED that, in the exercise of discretion, the claims of allegedly defrauded stockholders are classified as subordinate to the claims of conventional general creditors." (A. 446).

The fact that the exercise of the District Court's discretion harmonized with the general rule as announced in *F.D.I.C. v. American Bank Trust Shares, Inc.*, 412 F. Supp. 302, 308 (1976), *Carter v. Bogden*, 13 F. 2d 90 (1926), *Scott v. Abbott*, 160 F. 573 (1908), *cert. denied* 213 U. S. 572, 53 L. ed. 655, and *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713 (W.D. Mich. 1938), strengthens the case for affirmance.

POINT II

Answering Appellants' Point II.

Under their Point II appellants argue that the bank creditors did not rely on the capital contributions of the so-called defrauded stockholders and therefore the claims of such stockholders should be ranked with the banks' claims. We assume that this point and appellants' Point III will be answered in detail by the bank appellees but notwithstanding such assumption, we express our views as follows:

In the first place, this point was not made in the court below (A. 195-265) and is not, therefore, available on appeal.

Furthermore, as stated by the 8th Circuit in *Carter v. Bogden*, 13 F. 2d 90, 93 (1926), "Any one becoming a creditor of a corporation has a right to rely on the security afforded by the money or assets paid in by the stockholders for its capital stock" (Emphasis added) and, as the District Court in our case noted, banks, suppliers and others extend credit on their "*presumed right* to be accorded priority over the claims of investors and speculators in securities" (A. 444). (See, also, discussion under Point I, *supra*.) Judge Wyatt put the proposition well in his opinion in *Matter of Weiss Securities, Inc.*, 425 F. Supp. 212, 217 (S. D. N. Y. 1977) where he said, "If the reliance doctrine must be satisfied as a point of dogma, it should be presumed as a matter of law."

The undisputed sequence of events in the case at bar seems clearly to support the presumption that the banks relied upon the equity capital furnished by the stockholders.

Over nine million shares of the common stock of Stirling Homex Corporation were issued and outstanding at the time the appellee banks made their first loans in early 1971 (A. 177). Five hundred thousand shares of convertible preferred stock were issued on July 31, 1971 (A. 176). The new loans which gave rise to the banks' claims herein were made in January of 1972 (A. 81). Important to note is the fact that the 500,000 shares of convertible preferred stock were issued on July 31, 1971 for the express purpose of raising working capital and of reducing bank indebtedness (A. 348). Obviously, the banks knew this. See Registration Statement (A. 348), which reads in part as follows:

"As of June 30, 1971, the Company had outstanding \$37,450,000 of short-term indebtedness to banks which had been incurred for working capital purposes. The Company estimates that substantially all the net proceeds from the sale of its shares offered hereby will be applied initially to the temporary reduction of such indebtedness. The Company intends to continue to make short-term borrowings from banks in substantial amounts for working capital purposes. See 'Business-Sales'."

Appellants at page 21 of their brief make the unsubstantiated statement that "bank credit would continue to be extended to Stirling Homex, *regardless of the outcome of the preferred stock offering*" (emphasis that of appellants). They cite (A. 272) and (A. 390) in support of this statement. The record at these referenced pages does not support the statement made and emphasized. No such statement appears in the record. All that appears is that a Mr. Hazen of the Chemical Bank at the time of the offering stated that the Chemical Bank "had every intention of continuing to extend credit to Homex but that Chemical wanted such extension of credit to be made pursuant to a formal-

ized revolving credit agreement with adequate controls, particularly to curtail the speculative building of modules" (A. 390)—in other words, after the banking situation was renegotiated. Appellants' underlined statement, "regardless of the outcome of the preferred stock offering" nowhere appears and obviously was not included in Mr. Hazen's statement or intentions and is nothing but a groundless and self-serving assertion by way of a conclusion by appellants. The loans were made in January of 1972, months later and after extended negotiations—importantly, months after the preferred stock was issued. In the nature of things the banks obviously relied on the "cushion" provided by the proceeds of the preferred stock issue.

As stated in the brief of the Securities and Exchange Commission, p. 3, "When these loans were being made and when its securities were being sold and traded, Stirling Homex appeared to be a successful business, reporting increasing sales of modules and installations during at least 1970 and 1971." The picture from the lender's point of view was made "rosy", to use the Commission's words, by the infusion of \$19 million of cash representing the proceeds of the preferred stock issue.

POINT III

Answering Appellants' Point III.

Under their Point III appellants argue for the first time that "The banks' claims should be equitably subordinated to the fraud claims of the preferred stockholders and of many of the common stockholders, upon their establishing that the banks aided and abetted the issuance of a false prospectus for the preferred stock."

No such contention was made in the court below (A. 191-265).

What is now suggested by way of afterthought and a latterly conceived makeweight is that "The preferred shareholders, past and present, should have the opportunity to establish that the banks were implicated in the prospectus fraud."* (appellants' br. p. 45). Appellants' brief then states, "If the stockholders succeed, the banks' claims should be subordinated to those of the defrauded stockholders." It is significant and determinative of this point that appellants do not even argue that they have made a showing of fraud on the part of the banks—nor have they. They seem to argue that the long suffering orthodox and conventional creditors should step aside and wait years apropos of some sort of remand while the so-called defrauded stockholders pursue an attempt to develop this nebulous afterthought.

Furthermore, as stated in appellants' brief at p. 44, "This claim is made in the third count of *Jezarian v. Csapo*, the previously mentioned certified class suit pending in the District Court for the Southern District of New York." This is the suit which after almost six years is still in its discovery stage. If there is any merit to the claims of these so-called defrauded stockholders in this regard they can establish it in their class action against the Chemical bank.

* They have had such an opportunity—indeed, a full and complete opportunity (A. 191-265).

POINT IV

Comments concerning appellants' Points IV and V

Rather than relying upon the proposition that the holders' fraud claims are precluded by the bar order December 11, 1972 (A. 24), the Trustee prefers to have the fundamental question of the validity of the subordination of the so-called defrauded stockholders' claims to the claims of the orthodox and conventional general creditors decided on the merits. If the claims of so-called defrauded stockholders are properly subordinated to the claims of orthodox and conventional general creditors, then the effect of the bar order and the sufficiency of its service are moot under the facts of this case. Notwithstanding the Trustee's position in this regard, certain comments or observations concerning appellants' Points IV and V are in order.

First of all, each and all of the named appellants not only received notice of the bar order (appellants' br. p. 55) but each of them received other notices during the course of the proceedings.*

"The Bankruptcy Act in effect presumes that once a creditor knows of a pending bankruptcy proceeding, the creditor will be able to identify any debts owed by the bankrupt, and will then take appropriate action. It assumes that the creditor knows his own debtors, how much they owe, and the nature of the debts. Thus, the

* Appellants Harry E. Jones and Aleck Goldberg not only received notice of the bar order but filed claims within the time limited by the order (A. 27). Appellants Gregory Jezarian, Geraldine Jezarian and Lonetown admit receipt of the bar order but assert that because of their belief that the banks had "priority claims which would exceed the amount of the distributable assets, so that general creditors would take nothing", they filed no claims within the time limited by the bar order (A. 412). *Importantly, they represent past and present stockholders as a certified class* (A. 213, 214, 258).

statute provides that mere knowledge of the proceedings is a satisfactory alternative to due scheduling. *There is no requirement that the creditor be made aware of any particular debt* (citing cases)." (Emphasis added.) *Cherron Oil Company v. Edward H. Dobie*, 40 NY 2d 712, 716 (1976).*

Secondly, appellants' statements such as the following, ". . . the text of the bar order explicitly excepted stockholder fraud claims;" (appellants' br. p. 46) are in error. The bar order pertained to

"All proofs of claim of creditors against the debtors or their property, of whatever character, either in tort or in contract, fixed or contingent, liquidated or unliquidated, other than those founded on bonds, bond interest coupons or shares of stock. . . ." (A. 24; appellants' br. p. 47).

Appellants' latterly thought-of claim that the Trustee should have mailed notice of the bar order to "all purchasers of Stirling Homex stock since the company went public in 1970" and solicit fraud claims is without merit. The Trustee mailed the notice strictly in accordance with the order of the court respecting the giving of notice (A. 24, 42). Apropos of appellants' claims in this regard the Trustee has caused a survey to be made of all reported Chapter X bankruptcy proceedings in which bar orders have been made and is advised that in no one of them absent a settlement has notice of such an order been sent to *past* stockholders, let alone to *all past* stockholders.

* The foregoing italicized statement is a complete refutation of the claim that the Trustee should now be directed to "*solicit*" fraud claims from the past and present stockholders.

It is true that after the *settlement* and on *consent* of all parties, the District Court in the *Westec* case extended the bar order, as stated in appellants' brief at p. 59, but this is beside the point.

We conclude our discussion of the matter of notice with the following quotation from p. 55 of appellants' brief:

"Concededly, all the appellants were shareholders of record on December 29, 1972, so that none of them is aggrieved by the failure to mail the bar order (assuming that it encompassed the claims in question) to the former stockholder-creditors whose names and addresses were known."

Their names and addresses were not known and could only be ascertained in part by recourse to the voluminous transfer sheets and at great expense. Thousands of shares traded by speculators who kept their shares in "street name" could never be identified.

A direction to search for names and addresses of all past stockholders, numbering thousands, to solicit from them claims and process such claims, to say nothing of auditing and litigating them, will place an impossible burden on the Trustee whose personnel now consists of three persons.

Conclusion

For the reasons stated herein the order under review should be in all respects affirmed.

Respectfully submitted,

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77-5019, 77-5022

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